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The Rediscount and Acceptance System

By CHARLES A. CONANT, Author of "A History of Modern Banks of Issue"

TWO measures of banking practice were given legal recognition by the Federal Reserve Act of 1913, which were before little known and still less employed by American bankers. These were the rediscount of commercial paper and the giving of banking acceptances. By the operation of these two measures bank assets had long possessed in Europe a mobility, or exchangeability, which they lacked in the United States. As expressed by Mr. Paul Warburg, Europe had not only mobilized its permanent investments, by putting them into the form of bonds and shares of joint-stock companies, but had "in addition mobilized its temporary investments, by changing the promissory note, or 'bill,' into a 'bill of exchange' and by creating large discount markets where these 'bills' can be 'exchanged' freely at any time."*

Means of rediscounting on a broad scale were provided in the United States by the creation of the Federal Reserve banks, and opportunities were afforded by the advent of the European war, which would otherwise have come slowly, to put the new system in force.

As discount of a promissory note or bill is a purchase by the banker who takes it for discount, so rediscount is merely the passing of it along to another purchaser. In banking practice, however, in Europe, the rediscount is granted by a banker to a banker and usually by the central bank of issue to a joint-stock bank or private banker. The note or bill, in passing through the hands of the banker making the original discount, acquires his endorsement and thereby binds him to make good the amount of the instrument in case of default of the maker or drawee. Where an acceptor appears in the transaction, it is usually a banker or an accepting house of established resources and reputation, who by acceptance assumes the obligation to pay at maturity which rested originally upon the maker only. Thus, a bill which has been accepted and rediscounted acquires a number of strong endorsements, which make it the best form of temporary investment. As such, it is eagerly sought by bankers as almost the equivalent of cash, because the strength and reputation of the endorsers ensure its soundness; its early maturity ensures its convertibility; and it has the advantage over cash of affording an income.

In the United States "one-name paper"—that is, the direct promissory note of the maker—is the chief form of security by which loans are obtained from banks. Such paper, however, remains usually in the custody of the lending bank from the date of the loan to the maturity of the paper. In Europe a bill usually bears the added security of the name of the drawee, being in the form of a draft upon a debtor by his creditor requiring payment on a stipulated date, in accordance with the contract originally made when the goods were sold which give rise to the debt. Acceptance is defined by Mr. Withers as "nothing else than the promise of the party on whom the bill is drawn that he will pay it at due date; and this acceptance he signifies by writing his name across the face of it." A definition which is technically more complete,

*"Banking Reform in the United States," p. 130.

as the obligation is interpreted under the French Code of Commerce, is as follows:*

"ACCEPTANCE.—This is the act by which the person drawn upon engages to pay the amount of a bill of exchange to the person who may be at maturity the regular holder of such bill. It is accomplished by the endorsement on the bill of exchange of his signature made by the drawee, preceded or not with the word 'accepted' (Art. 122). Acceptance, besides the general conditions relative to consent, must be the work of a person capable of obligating himself by a bill of exchange. It may be partial, but not conditional (Art. 124). Its effect is to create an obligation on the part of the drawee toward the holder at maturity, with all the consequences attached by law to obligations arising from a bill of exchange."

Under the system of acceptance, a bill which might be presented by a joint-stock bank or private banker to the central bank for rediscount would have at least three guarantees—that of the drawer, who would be liable to his banker if he obtained a loan on a draft which was not honored at maturity; that of the drawee who had affixed his acceptance; and that of the bank which had originally discounted the bill. Obviously, the difference in the degree of security and negotiability between such an instrument and American one-name paper fully justifies the opinion expressed by a prominent banker, now a member of the Federal Reserve Board:†

"In the United States our commercial paper is the old promissory note, it is a *bill;* in Europe commercial paper is a *bill of exchange.* I think that I cannot more forcibly express the difference between the two. In the United States this promissory note is an investment, in Europe it is a means of exchange. If, in the United States this promissory note has entered the bank, it usually remains there until it falls due; if a New York bank, under normal conditions, should try to rediscount such paper, it would create suspicion and distrust. This means that every dollar invested by a bank in American commercial paper, that is, every dollar invested to satisfy the most legitimate requirements of business, leads, without fail, to a locking up of cash in unsalable assets."

Dictionnaire du Commerce, de l'Industrie et de la Banque, Guyot et Raffalovich, Vol. I, p. 22.

†Warburg, p. 33.

OPERATIONS OF A CENTRAL BANK.

WHERE a central banking mechanism exists, ready to rediscount accepted paper, it constitutes a reservoir of credit upon which other banks may draw whenever they need additional resources. The possession of paper known to be available for rediscount constitutes in itself, for the bank which holds it, a reserve which is practically the equivalent of cash because it can be quickly converted into cash or into a cash credit. The ability of the central bank to grant such credits is restricted only by the rules of sound banking which are prescribed for it by enlightened financial opinion or by statute. If its power of note issue is practically unhampered, its power to aid the money market in emergencies is adequate for the gravest crises. By the possession of a gold reserve sufficient to inspire absolute confidence, the central bank has been able on such occasions to proclaim to the mercantile and banking community that it was ready, by the temporary substitution of its own credit, to relieve the congestion in the flow of credit which under more normal conditions permitted the liquidation of the credit instruments growing out of the free movement of commodities from producer to consumer.

The policy pursued in regard to rediscounts varies considerably at the principal banks of Europe. The Bank of France comes nearest to realizing

its logical position as defined by Governor Pallain as "a bank of banks." By reason of the fact that the joint-stock banks are able in case of need to rediscount their best paper at the Bank of France, they are released from the necessity of maintaining large metallic reserves of their own and are able to apply a large percentage of their deposits in direct discounts, in advances on collateral, in the purchase of commercial paper, and in other commercial operations. As this process was tersely outlined by one of the officials of the great French bank, the Credit Lyonnais, in testifying before the American National Monetary Commission:*

"In France we have the Bank of France, which regulates the currency of the whole country; and any bank, if it has need for additional cash, may present for rediscount at the Bank of France the bills and other commercial paper which it has in its vaults. The amount we carry at the Bank of France may vary greatly according to circumstances. It is not to our advantage to have too large a sum at the bank, because the Bank of France does not allow any interest. * * * The excess of deposits is invested almost entirely in commercial paper available for discount with the Bank of France at any moment and in *reports* (loans on securities from one stock exchange settlement to another)."

One of the essential differences in method between the Bank of France and the Bank of Germany is the requirement of the statutes of the former that paper which is not secured by collateral shall be discounted only when it bears three solvent signatures. This has the effect of excluding from the portfolio of the Bank of France paper bearing only the names of the drawer and drawee and lacking the endorsement of a bank. This requirement has been a subject of some complaints in France and was an object of attack on the occasion of the renewal of the bank charter in 1897. The demand that the bank be authorized to discount paper with two signatures was defeated in the Chambers by a majority of only forty votes. It was contended by such strong men as Millerand and Viviani that the existing system imposed conditions which were unnecessarily onerous and created a sort of subordinate monopoly for the banks of discount.† It was pointed out on behalf of the bank, that the requirement of the third signature was a logical consequence of the policy of limiting discounts to paper which was actually based on commercial transactions. While the acceptance of the drawee afforded *prima facie* evidence of this, it did not exclude collusion to the same extent as the added endorsement of the local bank, whose familiarity with local houses and with the personal credit of those at their head enabled it to pass with sound judgment upon the paper presented and to employ the Bank of France merely as an agent of rediscount.‡ If they saw fit to admit accommodation paper to their portfolios, it was a matter of their own concern, and did not vitiate the liquid character of the assets of the Bank of France, accepted for a century as the best guarantee of the soundness of business in France.

The argument which was most effective with the majority, however, and with most competent economists, was that a modification of the rule of three signatures would benefit only a class of commerce of moderate importance and would weaken the position of the Bank of France. It was evident that if the bank should be authorized to discount paper with two signatures, it would be able to carry out the policy in practice only with respect to houses of notorious soundness and not for small merchants, whom it was the object of its critics to aid.§ If the bank should be directed to accept bills with

*"Interviews on Banking and Currency Systems," Senate Document No. 405, 61st Congress, 2nd Session, p. 224.

†E. Kaufmann, *La Banque en France,* p. 277.

‡Cf. Huart, *L'Organization du Crédit en France,* p. 78.

§Kaufmann, p. 278.

two signatures, and should comply with the requirement, it was pointed out that those now deriving the benefit of rediscount, through the addition of a banking signature to their paper, would be crowded aside by the strong paper with two signatures and the net result would be less favorable to commerce of minor importance and more favorable to the great mercantile houses and industrial establishments. The opening of the doors of the Bank of France to paper of moderate importance and bearing only two signatures would put it in competition not only with the great credit societies, but with the local banks which were already conducting a struggle for existence against the larger institutions. As it is the local banks which supply the credit of a personal nature which cannot be readily obtained from the three great credit societies, in view of the methods employed at their branches, anything which tended to cripple them further would tend still further also to the injury of commerce of the lesser sort.

In Germany the law states that the Imperial Bank has the right to "buy, sell, and discount bills which mature within a maximum period of three months and which are indorsed by three, and in exceptional cases by two, persons who are known to be solvent." In practice, however, this has been interpreted as making compulsory the requirement of two signatures, and thereby putting a restriction upon the policy of the old Bank of Prussia (of which the Imperial Bank is the heir), which in exceptional cases discounted bills with only one signature. An ordinance of the Prussian Bank dating back to 1829 permitted the purchase of unaccepted drafts from reliable parties. It was the intent of the Imperial Bank Act of 1875 to eliminate this risk by limiting purchases to bills which bore the signature of the drawee as well as the drawer. The test of solvency is also made as rigid as possible. Persons obtaining credit must be well known to the executive officers as reliable and hence at the branches must usually be persons whose residence is within the business circuit. Knowledge of the economic purpose of the bill is another requirement usually enforced, and in general the requirements of the Imperial Bank are met only by a bill which starts from a completed transfer of property between the parties liable on it and is destined at its maturity to offset this transfer.*

At the National Bank of Belgium the requirements for the discount of paper are similar to those at the Bank of France. The fundamental condition, although subject to some qualifications, is that paper accepted for discount must bear three solvent names. While the Bank of Belgium is not so distinctively a "bank of banks" as some of the central banks of Europe, the tendency of the requirement of three names is to limit the discount business to a large extent to rediscounts. By a system peculiar to Belgium, paper sent in from the agencies of the bank usually bears the endorsement of a body known as the discount bureau (*Comptoir d'escompte*), whose field of operations in the majority of cases is similar in area to that of the agency. These bureaus are usually private partnerships, which are willing for a small commission to examine the paper presented to the agency for discount and become liable for that to which they give their endorsement. They thus correspond in some senses to bill brokers, but differ from them in assuming full liability for the paper which they approve, thereby acquiring more of the character of underwriters or insurers.† While the signature of the discount bureau is not in itself construed as acceptance, the larger proportion of the discounts held by the National Bank has usually consisted of

*The Reichsbank, 1876-1900, National Monetary Commission, Senate Document No. 408, 61st Congress, 2nd Session, pp. 127-30. Cf. Interviews on Banking and Currency Systems, p. 339.

†For the details of these organizations, *vide* the author's "National Bank of Belgium," National Monetary Commission, Senate Document No. 400, 61st Congress, 2nd Session, pp. 115-20.

accepted paper, although the practice of extending accommodation directly to small merchants and manufacturers has given a great preponderance in number of pieces discounted to paper which has not been accepted.*

In England the relations of the central bank with the joint-stock banks are less direct under normal conditions than in France and Germany. Much business is done by the Bank of England in advances on collateral security. Commercial bills are purchased chiefly by intermediaries who are known as discount companies and bill brokers. The latter obtain credit from the banks by depositing bills as security for loans on call or by direct sales of bills to the joint-stock banks. The latter regulate their supply of loanable funds by calling in their loans to these bill houses when their resources are depleted. It is only when such calls have imposed upon the bill houses the necessity of finding money elsewhere that they turn to the Bank of England, which then discounts for them directly. In such cases, "short-bills"—those having but a part of their entire period to run—are presented to the Bank of England for discount.

Thus, the bank, while holding itself more or less aloof from the bill and acceptance market in times of financial tranquillity, forms a sure refuge for the money market in periods of stress. The bank requires two London names on bills which it discounts, but a bill accepted by a London firm and endorsed by a London bill-broker fulfills this requirement.† The joint-stock banks, knowing that the bill-brokers can rely on the bank in this way, in case of need, do not hesitate to call in their loans to bill-brokers if their cash and deposits at the Bank of England become depleted. They are thus able to count upon these loans as a second line of reserve, much safer and more convertible than the "call loans" on securities which were formerly relied upon by the New York banks to perform this function. ‡

In France and Germany, where the large joint-stock banks have less hesitation in rediscounting freely with the central bank, discount companies and bill-brokers are largely eliminated and short bills are sent directly by the joint-stock banks to the central bank, either in settlement of balances or to obtain advances of cash.§

The official rate of discount at the Bank of France and the Imperial Bank of Germany is higher in times of business tranquillity than the rate at the private and joint-stock banks. Even in Germany, in spite of the pressure upon its supply of circulating capital, even in time of peace, a private bank will take bills for discount running three months or more and hold them as an investment, sending them to the Imperial Bank for rediscount, in case of need, when they have only about ten days to run. As no interest is paid by the Imperial Bank upon deposit accounts, there is no inducement to the other banks to keep with it larger balances than are required by prudent banking policy.¶ The German bank, however, has obtained command over the supply of floating capital necessary to carry on its large volume of business by extending its activities into the field of transferring funds between different places in the Empire. This has had the effect of placing a large aggregate of funds constantly in its hands in the form of transfer accounts of merchants, which cannot well be reduced by their owners even in periods of stress.‖

The proportion of the paper discounted in France which passes through

*During the year 1908 the number of pieces of paper discounted, with acceptance, was 576,805, with a value of 1,259,104,000 francs ($243,000,000); of paper without acceptance, 3,846,641 pieces, with a value of 1,245,146,000 francs ($240,300,000).—"The National Bank of Belgium," p. 47.

†Withers, "The Meaning of Money," p. 164.

‡Cf. Withers, p. 148.

§Warburg, p. 140.

¶Interviews on Banking and Currency Systems, National Monetary Commission, Senate Document No. 405, 61st Congress, 2nd Session, p. 346.

‖Kaufmann, p. 70.

the Bank of France is calculated from the stamp tax returns and the records of the bank at approximately forty per cent. of the total amount in circulation. The proportion varies from year to year according to the state of the money market and the demand for rediscounts, and undoubtedly reached a much larger proportion than usual during the autumn of 1914, after the outbreak of the European war. Out of an annual average amount of paper stamped during the five years ending with 1910, amounting to 36,776,000,000 francs ($7,100,000,000) the average passing through the bank was 14,510,000,000 francs ($2,830,000,000), which constituted a proportion for these five years of thirty-nine per cent.* In Germany calculations based upon similar data indicate that the value of the paper passing through the Imperial Bank ranges from thirty-five to forty per cent. of the total amount stamped. In 1907 about 30,000,000,000 marks ($7,130,000,000) paid the tax, of which about 12,000,000,000 marks was discounted by the bank.†

The proportion of paper outstanding at any one time which is in the custody of the bank differs materially from the proportion passing through the bank, because of the difference in maturities. Paper which may have sixty days to run, for instance, may not be presented to the central bank for rediscount until the time remaining to its maturity is reduced to thirty days or even to a week. One of the standing rules at the Bank of France, in regard to bills discounted for collection outside of Paris, is that "Discount is collected for *five days* on paper drawn on branches and for eight days when drawn on auxiliary bureaus or connected villages, when maturity is of nearer date.‡ At the Imperial Bank of Germany it was found necessary a few years ago to impose a higher rate on paper rediscounted a few days before the quarter ends than at other times of the year. These short maturities for bills reaching the central bank reduce materially the ratio of paper in the hands of the bank to the total amount outstanding at any single date, and account for the fact that in France the net proportion of paper held by the bank is nearer one-eighth of the total amount in the market at a given time than the forty per cent. of the total issues which passes through the discount bureau of the bank. Thus, for 1912, the average circulation of commercial paper outstanding in France was estimated from the stamp tax receipts to be 10,730,000,000 francs ($2,070,000,000), while the average amount held by the Bank of France was only 1,333,000,000 francs ($257,000,000).

The extent to which the central banks of Europe operate as reservoirs of credit for the joint-stock banks is indicated by the statement of M. Pallain, Governor of the Bank of France, that his estimate of the proportion of the paper passing through the bank which bore another banking endorsement was about seventy per cent. of the total.§ The estimate made by the officials of the Imperial Bank of Germany was that about sixty per cent. of the paper in the vaults of the bank bore endorsements by other banking institutions.¶

The fact already stated, that the ratio of paper passing through the Bank of France is much in excess of the ratio of paper outstanding held by the bank at a given moment, illustrates one of the elements of strength of the central banking system. The shorter the maturites of the paper held by a central bank, the more liquid are its resources. Most commercial paper runs from two to four months, but foreign bills often run for a longer time.

*Roulleau, *Les Règlements par Effets de Commerce*, p. 42.

†Von Lumm, *Politique d'Escompte, Revue Economique Internationale*, June, 1912, p. 455.

‡*Vide* form of "bodrereau," or list, model No. 10, Combat, *Banques et Opérations de Banque*, p. 44.

§Interviews on Banking and Currency Systems. National Monetary Commission, 1910, Senate Document 405, 61st Congress, 2nd Session, p. 197.

¶Ibid, p. 341.

The central banks, however, usually restrict the limit of paper which they are willing to discount to that having sixty days to run. In the case of France, analysis of the bills of exchange of all classes which pay the stamp tax indicates an average maturity of about eighty-three days, but the average is considerably longer for foreign bills. The average maturity of paper held at the Bank of France, however, is usually under thirty days. This average for 1912 was 25.45 days and in 1913, thirty days. At the Imperial Bank of Germany, the time is somewhat longer, because of the greater proportion of German capital embarked by the German stock banks in industrial enterprises. The average maturity of discounted paper at the Imperial Bank is thirty-five to forty days, and this fact reacts upon the proportion of paper outstanding held by the bank at any given moment, which averages about fifteen per cent.*

In normal times the big joint-stock banks do not in any of these countries rediscount with the central bank paper of long maturity. In the absence of special pressure, the payment of maturing paper and of loans on call meets the daily demands for cash. If the demand reaches larger dimensions, short maturities are sent to the central bank. It is a sign of abnormal conditions, and the signal for the exercise of caution, when the other banks begin to offer bills of long maturity to the central bank for rediscount.

*Roulleau, p. 91.

From THE BANKERS MAGAZINE, May 1915

The Rediscount and Acceptance System

By CHARLES A. CONANT, Author of "A History of Modern Banks of Issue"

REDISCOUNT UNDER THE FEDERAL RESERVE LAW

THE framers of the new monetary policy of the United States, which was embodied first in the plan of the National Monetary Commission and afterwards in the Federal Reserve Act of December 23, 1913, recognized the function of a central banking mechanism to be fundamentally that of rediscount. While certain other classes of business were permitted to the proposed central banking organism, the discount of commercial paper directly for individuals or corporations other than member banks was not among their powers. The provision of the Federal Reserve Act bearing on this subject declared that only "upon the endorsement of any of its member banks, with a waiver of demand, notice and protest by such bank, any Federal Reserve Bank may discount notes, drafts, and bils of exchange arising out of actual commercial transactions."[1] The plan of the National Monetary Commission provided a still further safeguard to the central banking organism, in the case of paper arising out of commercial transactions running not more than four months, by requiring that it must be guaranteed by the local association of which the bank asking rediscount was required to be a member.[2]

In the case of acceptances, their direct discount by Federal Reserve Banks was restricted to those having at time of discount not more than three months to run, and "indorsed by at least one member bank." The amount of such acceptances discounted was limited to "one-half the paid-up capital stock and surplus of the bank for which the rediscounts are made." A somewhat broader power was given to Federal Reserve Banks to purchase and sell in the open market, at home or abroad, bankers' acceptances of certain types, "with or without the endorsement of a member bank." Such operations were subject, however, to "rules and regulations prescribed by the Federal Reserve Board," and it was in virtue of this authority that "bankers' acceptances" were defined by the Board in regulations issued in February, 1915.

Thus, from the beginning, competition with other banks, and especially with their own member banks, for the direct discount of commercial paper, even to the moderate extent permitted to the central banks of Europe, was excluded from the Federal Reserve system. The Federal Reserve Board, in the exercise of its powers to determine or define the character of the paper eligible for rediscount, did not attempt at the inauguration of the system to make radical changes in the practices already prevailing among American merchants and bankers. In discussing the question whether the policy should be adopted at once of discounting only bills bearing two names besides that of the discounting bank, the Board defined its position as follows:[3]

"Double-name paper drawn on a purchaser against an actual sale of goods

[1]Federal Reserve Act, approved Dec. 23, 1913, Section 13.

[2]Cf. Horace White, "Money and Banking," p. 438.

[3]First Annual Report of Federal Reserve Board, Circular No. 13, November 10, 1914, p. 183.

affords, from the economic point of view, prima facie evidence of the character of the transaction from which it arose. Single-name notes, now so freely used in the United States, may represent the same kind of transactions as those bearing two names. Inasmuch, however, as the single-name paper does not show on its face the character of the transaction out of which it arose—an admitted weakness of this form of paper—it is incumbent upon each Federal Reserve Bank to insist that the character of the business and the general status of the concern supplying such paper should be carefully examined in order that the discounting bank may be certain that no single-name paper has been issued for purposes excluded by the act, such as investments of a permanent or speculative nature. Only careful inquiry on these points will render it safe and proper for a Federal Reserve Bank to consider such paper a "self-liquidating" investment at maturity."

QUALIFIED ENCOURAGEMENT OF THE EUROPEAN SYSTEM.

THE new banking system of 1914 thus entered tentatively, and in a guarded way, upon the encouragement of the European system of bills of exchange bearing two solvent signatures and capable of being converted readily into negotiable investments. It was admitted at the outset by those holding high places in the new system that only a few banks were engaged in the acceptance business, that there were practically no acceptance houses, and that, in consequence, the inducement to introduce the system of acceptances might lie in a preferential rate of discount rather than in a regulation.[4]

This view was adopted by the Federal Reserve Board in the regulations promulgated authorizing Federal Reserve Banks to enter upon the discount and purchase of acceptances. The first regulations promulgated by the Board, on February 8, 1915, defined an acceptance as follows:

"In this regulation the term 'acceptance' is defined as a draft or bill of exchange drawn to order, having a definite maturity and payable in dollars, in the United States, the obligation to pay which has been accepted by an acknowledgment written or stamped and signed across the face of the instrument by the party on whom it is drawn; such agreement to be to the effect that the acceptor will pay at maturity according to the tenor of such draft or bill without qualifying conditions."

The designation of "bankers' acceptances" was adopted for those which had been made "by a member bank, nonmember bank, trust company, or by some private banking firm, person, company, or corporation engaged in the business of accepting or discounting." It was provided that a banker's acceptance must be drawn by a concern "directly connected with the importation or exportation of the goods involved in the transaction in which the acceptance originated," and must bear on its face or be accompanied by satisfactory evidence of the fact, "that it originated in an actual bona-fide sale or consignment involving the importation or exportation of goods."[5]

It was suggested that such evidence might consist of a certificate to this effect. It was provided that bankers' acceptances other than those of member banks should be eligible for rediscount only after the acceptors "shall have agreed in writing to furnish to the Federal Reserve Banks of their respective districts, upon request, information concerning the nature of the transactions against which acceptances have been made." The aggregate of acceptances of private firms other than banks or trust companies, discounted or purchased by a Federal Reserve Bank, were limited to twenty-five per cent. of the paid-up capital of such bank. The policy of the preferential treatment for acceptances bearing the endorsement of member banks was thus defined by the Federal Reserve Board:

"The board believes it to be in accordance with the spirit of the act to accord preferential treatment to acceptances bearing the endorsement of member banks, offered for rediscount under section 13—even to the point of allowing lower rates for such acceptances, inasmuch as, under the terms of this section, such acceptances are available as collateral against the issue of Federal Reserve notes; and the board will sanction a slight preferential in favor of acceptances bearing the endorsement of member banks.

"When acceptances bearing the endorsement of member banks are not obtainable in adequate amount or upon satisfactory terms, Federal Reserve Banks desiring to purchase acceptances should restrict themselves, as far as possible, to such acceptances as bear some other responsible signature (other than that of the drawer and the acceptor), and preferably that of a bank or banker."

ACCEPTANCE SYSTEM NOT YET DEVELOPED

IN thus entering with moderation upon the policy of dealing in acceptances, the Federal Reserve Board justified its declaration that "the acceptance is still in its infancy in the field of American banking." Even in Europe, where the accepted bill is the standard form of paper in the discount market, acceptance is a special form of banking practised chiefly by a few houses which have had much experience in this class of business. In England, while acceptance is practised to a limited extent by the large joint-stock banks, their relation to the business is largely that of purchasers of paper which has been accepted by the discount houses. At the time of the European war, there were rumors in London accusing the banks of using "unfair discrimination against the bills of the accepting houses, and even of attempting to drive the latter out of the accepting business and keeping it all for one another"; but these suggestions are dismissed by Mr. Withers with the declaration that "the banks have not the necessary equipment for doing a large part of the business that is handled by the accepting houses."[6]

Some of the accepting houses, known as merchant acceptors, have been the product of an evolution from direct dealings in foreign merchandise in the Orient, Africa and Latin America, into the banking side of the business. These houses, having developed a high reputation for strength and solidity, were naturally able to obtain the discount of their bills on better terms than houses which were not so strong and well known. It suggested itself to the latter to secure the acceptance of their bills by the stronger houses, paying a small commission for the added credit, which would enable them to get back their commission and a little more through being able to finance their operations more easily and cheaply than by means of their own acceptances. Merchants of first-class credit, finding that they could rent out the use of their reputation at a profit, proceeded to specialize in this class of business by examining carefully the bills put before them for acceptance, keeping well informed on the means and standing of the drawers, and giving their acceptance, for a commission, to such paper as fulfilled their requirements.[7] Hence grew up a class of houses, still known as merchants in England, but performing functions which gave them a place in the financial world which in America would bring them under the general designation of bankers.

IMPORTANT ADVANTAGES OF REDISCOUNTS

ONE of the most important advantages accruing to the London market by the system of rediscounts is the

[4] *Vide* address of Benjamin Strong, Jr., Governor of the Federal Reserve Bank of New York, at luncheon of the Merchants' Association, November 23, 1914.

[5] Federal Reserve Board, Regulation D, Series of 1915.

[6] "War and Lombard Street," p. 73.

[7] Withers, "The Meaning of Money," pp. 160-162.

flexibility given by the system to the relations of the national money market with the international market. Commercial paper which has been accepted by a banking-house of first-class rank, having an established reputation in several money markets, is recognized as a safe and marketable investment in these international markets. It can be employed, therefore, in drawing capital into the market where it is scarce and reducing surplus funds in the markets where they are abundant. If the rate of discount at London, for instance, is five per cent.—that is, if first-class commercial paper of the type referred to, which is accepted or endorsed by strong banking-houses, can be bought on an interest basis of 5 per cent.—and if at the same time the discount rate at Paris is four per cent., French banks and the French financial public will be able to invest with profit in English bills of exchange. Thus, French money, in one form or another, will go to London to relieve pressure there and bring discount rates nearer to a uniform level. The same principle applies to German, Austrian and other foreign bills. During the monetary pressure which accompanied the panic of 1907, hundreds of millions of German paper were discounted in Paris, because the rate of discount at the Bank of France remained uniform at four per cent. while in Germany it was for a time at seven per cent.

The French bankers would not buy the unendorsed notes of an English, German or Austrian merchant about whose credit they were not fully informed, but they know the value of the acceptance or the endorsement of the foreign bankers who offer and endorse this paper for sale or for rediscount. They would not buy it probably unless they knew that it could be rediscounted, with their endorsement, at their own central bank, in case they were subject to a sudden need of funds. While only a small proportion of this business reaches the central bank in time of financial tranquillity, the fact that it stands ready to aid the market by discounting liberally enables other institutions to invest freely in first-class paper.

The absence of a discount market in New York, prior to the enactment of the Federal Reserve Act, was a serious detriment to American trade with the Orient and Latin America as well as to trade with Europe. The majority of shipments of merchandise from the United States to these countries, as well as from these countries to the United States, were financed by documentary bills drawn on European banks for acceptance. Even the limited number of acceptances granted by a few New York bankers were not readily marketable in the Orient and Latin America, because a broad market had not been established for American bills drawn in dollars.

FORMER METHODS OF FINANCING OUR FOREIGN TRADE

A TYPICAL illustration of the manner in which the foreign business of the United States was financed, prior to the war in Europe, is afforded by the case of a silk manufacturer in New Jersey, who might desire to buy raw silk in China. The purchase having been consummated by cable, the first thing done by the American purchaser would be to go to his banker in New York, lay before him a statement of the conditions of the bargain, and get the banker to issue a commercial letter of credit. Such a credit would be in the form of a letter to the London correspondent of the issuing bank, requesting him to accept the drafts of the seller of the silk in China up to a certain amount and under certain conditions. If the silk was bought on the basis of payment within four months, the credit would set forth that the drafts were to be drawn payable at four months' sight. The silk importer would send this letter of credit or cable its contents to the seller of the silk in China. The latter would then be in a position to put the silk aboard ship, receive from the steamship company a bill of lading, stating that the silk had been put aboard and was deliverable to the order of the banker in New York who issued the credit. The shipper having thus become custodian of the bill of lading and having properly insured the goods, would be in a position to draw a draft for the cost of the silk. This draft would be drawn in pounds sterling upon the London correspondent of the American bank and would have the bill of lading, an invoice and insurance certificate attached.

The reason why London figured in the transaction was that, prior to the war, drafts on London were more readily negotiable than on any other place in the world. The shipper of the silk in China would sell the draft with attached documents to a local banker, who was usually the representative of an English colonial bank. The shipper would receive cash in local currency, thereby closing his interest in the matter. The draft would then be forwarded by the purchasing bank and presented by its representatives to the London correspondent of the New York bank which had granted the credit. It is the function of this correspondent to "accept" the draft, thereby indicating that it will be paid four months from the date of its presentment. For this service the London bank receives a commission which may be one-quarter of one per cent. for thirty days, one-half per cent. for sixty days, three-fourths of one per cent. for ninety days, and so on. Actual rates, however, usually range lower, in the case of drafts for four months, to about five-eighths of one per cent. This compensation the London banker receives for lending the use of his name and credit. He advances no money until the date for the payment of the draft, when it is the business of the New York banker, acting on behalf of the importer of the silk, to have the amount in the custody of the London banker to meet the bill.

The concentration of a vast volume of this class of business in London has been a source of great profit to London accepting houses and joint-stock banks. No money is involved until the remittance by the New York banker for final payment of the bill. The money for carrying out the transaction and out of which the shipper in China gets immediate payment, is largely furnished by London bankers who buy the bills after their acceptance.[8] It is, therefore, their capital which is invested directly in the operation; but the fact that such transactions are constantly taking place in London for large amounts makes it necessary for American and other foreign bankers to maintain deposits or credits in London and hence to furnish at least a part of the fund from which the profits of London bankers and acceptance houses are derived. English bills acquired the preference in international markets, partly because they were payable in gold at London and partly because of the customs and traditions which have created a broad and active market for such paper. Bills drawn on Paris in francs have a definite standing, and great efforts were put forth by the Germans prior to the European war of 1914 to extend the market for German bills. To facilitate this movement, however, it was found necessary to establish branches of the chief German banks in London, in order that they might give to their clients the advantage of drawing sterling bills and at the same time transfer the profits of such operations to the German banks at home.

FOREIGN CREDITS OPENED IN NEW YORK

OPPORTUNITY was afforded by the European war for a more rapid extension of the system of rediscount and acceptance in the United States than would probably otherwise have been the case. The appearance of several European governments as large purchasers of American supplies for carrying on the war, and the difficulty of making payments in the usual manner through bills of exchange, resulted in the opening of a number of important credits in New York. A typical case was the credit of $25,000,000 opened on

[8]This illustration is based upon the admirable analysis of Mr. Franklin Escher, "Elements of Foreign Exchange," published by the Bankers Publishing Co., New York, 1910, pp. 143-160.

behalf of the Russian Government with Messrs. J. P. Morgan & Company. It was arranged that a syndicate of New York bankers should, among them, both accept and discount bills drawn upon the Russian Government, running for ninety days, with an option on the part of the Government for a renewal for another equal term. It was reported that, in addition to a discount rate of 5 per cent., there was a commission of one-half of one per cent., which was to be repeated in case of renewal. In order to give the bills the proper standing as investments, it was agreed that the bills discounted by any institution should be only those which had been accepted by another member of the syndicate. The notes, which were in denominations of $10,000 and $25,000, were discounted and paid for by checks in favor of Messrs. J. P. Morgan & Company. The whole amount of the credit was thus placed at their command to pay for supplies as they were purchased.[9]

It was thought at first that these Russian bills might prove a valuable investment for the Federal Reserve Banks, but it was found that they did not fall within the definition prescribed by the Federal Reserve Board, that a banker's acceptance must be drawn by a commercial or other concern "directly connected with the importation or exportation of the goods involved in the transactions in which the acceptance originated." If the Russian Government had arranged that the bills should have been drawn upon a banker or broker, his acceptance would have made them a suitable investment for the reserve banks under the rules laid down by the Federal Reserve Board.

The growth of the acceptance system in New York is indicated by the policy adopted by one of the largest trust companies dealing in foreign exchange, in deciding early in March, 1915, to grant acceptances against raw cotton in warehouses. Such acceptances would not fall within the classification of the Federal Reserve Board, that they should be based upon the actual importation or exportation of goods, but the cotton was intended for export ultimately and its shipment was delayed only by the extraordinary difficulties of transportation and high rates for insurance caused by the war in Europe. Hence, the Guaranty Trust Company decided to accept the draft of shippers of cotton against the warehouse documents which usually accompanied a bill of exchange. While such acceptances could not be discounted under the Federal Reserve Act, the Guaranty Trust Company was not bound by that law and was already engaged, prior to its enactment, in the largest volume of acceptance business done in the United States. The amount of its acceptances already outstanding on December 29, 1914, including business done by its London branch, was $54,841,300.[10]

Gradually, as the convenience and security of accepted paper came to be understood among American bankers, other institutions entered the field as investors, and the discount rate for the best acceptances declined. By the close of January, 1915, acceptances were being granted by three national banks in New York, by one State bank, and by eight trust companies.[11] The rate at which such acceptances were first discounted was from 5 to 5½ per cent., but as their quality as quickly convertible assets came to be appreciated, the rate fell by the close of January to 2¾ per cent. and by the close of March, 1915, as low as 2⅛ per cent.

Doubts were expressed, when the Federal Reserve Act was pending in Congress, whether the American system of banking would afford an amount of paper suitable for rediscount which would be sufficient to enable member banks to obtain the aid they might need in periods of pressure. Bills of exchange had gradually fallen into disuse in American trade, and in many cases credit was granted by a banker to a manufacturer or wholesaler upon the security of his bills receivable—that is, the amount due to him by jobbers or

9"Wall Street Journal," February 10, 1915.

10"Wall Street Journal," March 31, 1915.

11"Wall Street Journal," January 27, 1915.

retailers who had not given any negotiable acknowledgment of their indebtedness. It was contended by many merchants that it would be extremely difficult to substitute for this practice the delivery of a negotiable instrument for a fixed amount covering each particular transaction.[12] It was pointed out, however, in the testimony before the Senate Committee while the measure was pending, that it was not necessary that all the assets of a bank should be in bills of exchange or acceptances, if there existed a marginal supply of such paper available for rediscount by the Federal Reserve Banks.[13] Such a marginal supply of paper is obviously in process of creation, and it has been found practicable, at least in certain trades, to employ bills of exchange and to convert them into negotiable instruments by securing their acceptance.

12It is declared by Holdsworth that, "In this country, cash payments are encouraged by the granting of trade discounts considerably more favorable than bank discounts." "Money and Banking," p. 360.

13Conway & Patterson, "Operation of the New Bank Act," p. 113.

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